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The Close Corporation and Section Nine of the New York Stock Corporation Law

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CURRENT LEGISLATION

THE CLOSE CORPORATION AND SECTION NINE OF THE NEW YORK STOCK CORPORATION LAW.—There have been few questions in the law on which textwriters and courts have differed more completely than on the subject of the close corporation.¹ It has been termed a "chartered"² or "incorporated"³ partnership, a corporation having five stockholders or less,⁴ and as "... an enterprise in corporate form in which management and ownership are substantially identical."⁵ The true concept of the close corporation is found in the nature of its attributes and the purposes of its formation rather than in any attempt at definition. It is usually composed of a few stockholders who have chosen the corporate form of doing business to avoid some of the disadvantages of the partnership, usually the unlimited liability peculiar to that entity. The members seek to establish an organization that is a corporation to the world but a partnership among the stockholders themselves. The individuals involved usually embody all the corporation's needs as to management, trade skill, capital, etc., and hold their stock only as evidence of their share of ownership. Dividends to the stockholder in the close corporation are not his main interest, in fact, they are seldom, if ever, declared. He looks to his salary as his return on his investment, and

¹ One writer comments, upon the attitude of the courts toward the close corporation as a "... blindness which has made the advocates of each unaware of the fact that there are corporations and corporations, and that the problems, needs and dangers involved in one may not be present in the other." Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273 (1929).

² *Ripin v. U. S. Woven Label Co.*, 205 N. Y. 442, 447, 98 N. E. 855, 856 (1912), wherein the court in speaking of the close corporation said: "By the Business Corporations Law three or more persons might form a corporation for any lawful business with certain specified exceptions, ... many businesses or private enterprises which formerly had been conducted by partnerships or individuals, became the subject of corporate control and ownership. Such corporations were little more (though not quite the same as) than chartered partnerships."

³ *Cuppy v. Ward*, 187 App. Div. 625, 639, 176 N. Y. Supp. 233, 243 (1st Dep't 1919), *aff'd mem.*, 227 N. Y. 603, 125 N. E. 915 (1919). Here the court said: "... although we are dealing with a corporate entity, its entire capital stock is owned by two individuals, in nearly equal proportions, who acquired and who hold the stock by virtue of a mutual agreement ... in such manner as to constitute what has frequently been called in this court an 'incorporated partnership.'"

⁴ Winer, *Proposing a New York "Close Corporation Law"*, 28 CORN. L. Q. 313, 335, 336 (1943).

⁵ *Israels, The Close Corporation and the Law*, 33 CORN. L. Q. 488 (1948).

wishes to protect this investment by exercising control over the management and policies of the corporation. Stock certificates to him, therefore, are no more than the indicia of voting power. With his stock, he seeks to accomplish two purposes, *i.e.*, to insure himself of employment by the corporation, and to control the policies and management thereof.⁶

In a partnership, partners are free to agree among themselves in whom control will be vested;⁷ and in the close corporation stockholders strive to attain this type of freedom in their organization. When incorporated, however, they must conform to the multitude of statutory regulations applicable to this creature of the state, and control and management must be vested in a board of directors,⁸ who in turn must act in behalf of the entity as such. Ordinarily, any agreement, either among stockholders or directors, which limits the discretion of the directors by creating a sterilized board, is void and unenforceable as against public policy.⁹

To attain this control, so necessary for the protection of his investment and employment, the stockholder in the close corporation has resorted to several devices designed to circumvent the statutory requirement of board action. By assuming a simple example of the close corporation setup, we may more readily appreciate some of the obstacles which bring about the use of these devices. Take a corporation composed of three members, each holding thirty-three and one-third per centum of the shares outstanding, each a director, and each employed by the entity. In the ordinary case, excluding any separate agreements or by-law provisions, it would always be pos-

⁶ For a more comprehensive discussion of the close corporation and its peculiar problems, see 1948 LEG. DOC. NO. 65(K), 1948 REPORT, LAW REVISION COMMISSION; Israel, *The Close Corporation and the Law*, 33 CORN. L. Q. 488 (1948); Winer, *Proposing a New York "Close Corporation Law"*, 28 CORN. L. Q. 313 (1943); Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273 (1929).

⁷ See N. Y. PARTNERSHIP LAW § 40.

⁸ See N. Y. GEN. CORP. LAW §§ 27, 28.

⁹ In *Manson v. Curtis*, 223 N. Y. 313, 323, 119 N. E. 559, 562 (1918), plaintiff and defendant, both stockholders and directors of the corporation, held between them the majority of the stock of the corporation. They agreed that the plaintiff would be vested with the sole and exclusive management and executive administration of the corporation and that the president, to be elected, would be only a nominal figurehead who would not interfere with plaintiff's management of the business. They further agreed to unite in the choice and election of six of the corporation's seven directors; and, it was their apparent intent, from reading the agreement as a whole, that the board of directors was to remain passive in the affairs of the corporation. The court held this agreement illegal and void on the ground that directors "... hold such office charged with the duty to act for the corporation according to their best judgment, and in so doing they cannot be controlled in the reasonable exercise and performance of such duty. . . . stockholders cannot . . . control the directors in the exercise of the judgment vested in them by virtue of their office. . . . Clearly the law does not permit the stockholders to create a sterilized board of directors."

sible for two of the members to effect the discharge of the third by acting through a majority vote of the board of directors as required by statute. One stockholder could, by the same token, be deprived of any control in policy or management; and the loss of this veto power would impair the value of his stock to that extent.

It is quite natural, therefore, for stockholders in close corporations to seek methods of preventing such action, thereby insuring their employment and salary. Several methods have been attempted to attain this goal of protection in spite of the maze of statutory regulations which were enacted primarily to protect the investor in the public-issue corporation. A requirement for a unanimous vote, either by separate agreement among the stockholders or among the directors, or in the by-laws would seem to be practical solutions. As was seen above,¹⁰ the two former methods are ordinarily void and unenforceable and the main objection to the by-law requirement is that it gives rise to an anomalous situation wherein a corporation might be rendered unworkable.¹¹ While this is undoubtedly true, it must be remembered that to look upon a close corporation in its proper light, it is a corporation *de jure* but a partnership *de facto*. The basis of the rule invalidating separate agreements when applied to the close corporation becomes untenable and impractical, for in such an entity we expect the stockholders and directors to be the same individuals. It is true that the rule is based upon the fact that directors owe their primary duty to the corporation; but, where the directors and the corporation are practically identical, it is manifest that it should not apply.

A review of the several leading New York decisions dealing with these agreements prior to the enactment of Section 9 of the New York Stock Corporation Law will best serve to show the success with which they were met by the courts. In the first of these cases, *McQuade v. Stoneham*,¹² defendant, a majority stockholder, sold shares of stock to the plaintiff and another and at the same time entered into an agreement with them that they would all use their best efforts to continue themselves as directors and officers at specified salaries as long as they continued to own the shares of stock held by them at the time of the agreement. The court, in holding the agreement invalid, said: "Directors may not by agreements entered into as stockholders abrogate their independent judgment."¹³ Later, in *Clark v. Dodge*,¹⁴ the court upheld an agreement entered into by all the corporation's stockholders, wherein the defendant agreed to vote his stock as a director to keep the plaintiff in control of the corpora-

¹⁰ See note 9 *supra*.

¹¹ See *Benintendi v. Kenton Hotel*, 294 N. Y. 112, 119, 60 N. E. 2d 829, 831 (1945), discussed in text *infra*.

¹² 263 N. Y. 323, 189 N. E. 234 (1934).

¹³ *Id.* at 328, 189 N. E. at 236.

¹⁴ 269 N. Y. 410, 199 N. E. 641 (1936).

tion and to insure his receiving one-fourth of the net income of the corporation by way of salary or dividends. The court there stated: "If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it invalid, even though it impinges slightly on the broad provision of section 27."¹⁵ The court there distinguished both *McQuade v. Stoneham* and *Manson v. Curtis*,¹⁶ recalling that in those cases all of the stockholders were not parties to the agreement. In view of these decisions it would appear that the deciding factor in determining the validity of these agreements would be whether or not all stockholders were parties to them;¹⁷ but the recent decision in *Ben-intendi v. Kenton Hotel*¹⁸ might lead to a different conclusion. In that case plaintiff and defendant owned one-third and two-thirds respectively of the stock of a small corporation. They entered into an agreement not to vote their shares against each other and if they failed to agree, not to vote at all. They also amended the corporate by-laws by embodying four by-laws requiring:

1. Unanimity for all shareholders' resolutions.
2. Unanimity for all elections of directors.
3. Unanimity for all directors' resolutions.
4. Unanimity for all amendments of by-laws by the shareholders.

Subsequently they disagreed and an action was begun in equity to have the by-laws declared valid and to enjoin the defendant from taking any action inconsistent therewith. The Court of Appeals held invalid by-laws (1), (2) and (3) and upheld the validity of by-law (4), saying that the first three were "... almost as a matter of law unworkable and unenforceable."¹⁹ With respect to by-law (1) the court stated that even in the absence of authority on the question the requirement of unanimity for all stockholders' resolutions is "... obnoxious to the statutory scheme of stock corporation manage-

¹⁵ *Id.* at 415, 199 N. E. at 642.

¹⁶ For a discussion of the facts and decision in this case, see note 9 *supra*.

¹⁷ *But cf.* *Matter of Buckley*, 183 Misc. 189, 193, 50 N. Y. S. 2d 54, 57, 58 (Sup. Ct. 1944), wherein the court stated: "Had the court intended to base its decision solely upon the fact that all the stockholders were parties to the agreement it could easily have done so without expressing the opinion that agreements which deviated slightly from section 27 were nevertheless legal if they harmed no one. That the Court of Appeals did not intend to predicate its holding solely upon the fact that all the stockholders were parties to the agreement is confirmed by the fact that the court disapproved of the 'broad dicta in the *McQuade* opinion' (p. 417) and declared that 'the broad statements in the *McQuade* opinion, applicable to the facts there, should be confined to those facts' (p. 417)."

¹⁸ 294 N. Y. 112, 60 N. E. 2d 829 (1945).

¹⁹ *Id.* at 119, 60 N. E. 2d at 831.

ment.”²⁰ The court asserted that the result of enforcing such a by-law, would be the deprivation of a representative form of government in that a minority interest would have an “. . . absolute, permanent, all inclusive power of veto.”²¹ The court also expressed the fear that a minority stockholder could prevent dissolution until such time as he should decide to vote for it. It would seem that this threat is not as dire as imagined in that a court of equity would in a proper case grant relief. By-law (3) was held to be opposed to the common law, and utterly inconsistent with sections 27 and 28 of the New York General Corporation Law and their legislative history. As to by-law (4) the court felt that while such a by-law is neither authorized nor forbidden, it involved no public policy or interest for it was not an attempt to escape the “. . . regulatory framework set up by law” nor “. . . such as will turn the corporation into some other kind of entity.”²² It is manifest that this decision made it impossible for close corporations to make any effective by-law provisions by which minority stockholders would attain the protection so avidly sought, at least so long as the then-existing statutory pattern remained in force.

The legislature, prompted by the decision in the *Benintendi* case, and by the recommendations of the New York Law Revision Commission,²³ enacted Section 9 of the New York Stock Corporation Law,²⁴ and thereby have given legal sanction to the close corporation. Section 9 reads as follows:

§ 9. Provisions of certificates of incorporation; requirement of greater than majority or plurality vote of directors and shareholders; restrictions

1. The certificate of incorporation as originally filed, or as amended by certificate filed pursuant to section thirty-five of the stock corporation law, may contain provisions specifying any or all of the following:

(a) that the number of directors who shall be present at any meeting of the directors in order to constitute a quorum for the transaction of any business or of any specified item of business shall be such number greater than a majority as may be specified in such certificate;

(b) that the number of votes of directors that shall be necessary for the transaction of any business or of any specified item of business at any meeting of directors shall be

²⁰ *Id.* at 118, 60 N. E. 2d at 831.

²¹ *Ibid.*

²² *Id.* at 121, 60 N. E. 2d at 832. See Note, *Limitations of Corporate By-Laws*, 19 ST. JOHN'S L. REV. 144 (1945).

²³ 1948 LEG. DOC. NO. 65(K), 1948 REPORT, LAW REVISION COMMISSION.

²⁴ Laws of N. Y. 1948, c. 862, § 1, as amended, Laws of N. Y. 1949, c. 261.

such number greater than a majority as may be specified in such certificate;

(c) that the number of shares of any class having voting power, the holders of which shall be present in person or represented by proxy at any meeting in order to constitute a quorum for the transaction of any business or any specified item of business at a meeting of the stockholders shall be a number greater than the majority or plurality prescribed by law in the absence of such provision;

(d) that the number of votes or consents of the holders of shares of any class of stock having voting power that shall be necessary for the transaction of any business or of any specified item of business at a meeting of the stockholders, including amendments to the certificate of incorporation, or the giving of any consent, shall be a number greater than the majority or plurality prescribed by law in the absence of such provision.

2. (a) A requirement for a quorum, vote or consent of directors or shareholders, which is invalid except for the authorization therefor granted by this section, shall not be valid hereunder unless (i) it appears in the certificate of incorporation as originally filed or as amended by certificate filed pursuant to law; (ii) notice of its existence appears plainly on the face or back of all stock certificates; and (iii) it specifies a period no longer than ten years for its duration.

(b) An amendatory certificate filed pursuant to law containing a requirement authorized by this section shall be subscribed and acknowledged by every subscriber of the certificate of incorporation and every subscriber to stock if no stock has been issued, or in person or by proxy by the holders of record of all the outstanding shares of the corporation. Such certificate may be amended at any time in the same manner.

3. The requirements specified pursuant to subdivision one of this section, may at any time be renewed or extended from time to time for further periods, not exceeding ten years each upon compliance with the provisions of this section.

4. Nothing herein contained shall be construed to limit the power of a court of equity to decree a dissolution in a proper case.

The foregoing section seeks to afford to a close corporation the unanimity concept of control that has always been inherent in a part-

nership and sought by the close corporation. It is apparent, therefore, that by complying with the conditions provided for in the section, the stockholders in the close corporation can effectively achieve that measure of control and veto power necessary to protect their interests.

It should be noted, however, that this section is only permissive, and in order to take advantage of the changes effected by it, the corporation must comply strictly with the conditions precedent found in subdivisions (2) and (3). Subdivision 2 (a) (i), requiring the provisions for unanimity or qualified majority to appear in the certificate of incorporation itself rather than in any by-law or extrinsic agreement, assures the existence of a public record of the requirement and of its terms and conditions. The original certificate or any amended certificate of incorporation containing the requirement will be on file in the office of the Secretary of State as required by law,²⁵ and will, therefore, be available to the public for inspection at any time.

Subdivision 2 (a) (ii), requiring that notice of the existence of the provision appear plainly on all of the stock certificates gives ample notice to those who may subsequently become stockholders.²⁶ Since the highest degree of united action is required to continue under this statute, it would appear that where a minority stockholder becomes enmeshed in, or envisions, unharmonious relations because of a change in his relationship with the other stockholders or for any other reason, a path back to majority rule has been provided by subdivision 2 (a) (iii) which limits the period of duration of any provision adopted under this section to ten years. A shareholder might well determine to compromise during the remaining limited term rather than effect a dissolution.²⁷ There will be no problems of dissenting minority stockholders, because subdivision 2 (b) requires the unanimous consent of all stockholders and/or subscribers to the certificate or stock, if no stock has been issued, before any provision permitted by the section may be adopted. It should also be noted that after the expiration of ten years Section 9 will have no effect and activities of shareholders and directors will be without its scope

²⁵ N. Y. GEN. CORP. LAW §8(2).

²⁶ See Israels, *The Close Corporation and the Law*, 33 CORN. L. Q. 488, 506 (1948), for a sample form of compliance with Section 9 on a stock transfer certificate.

²⁷ A provision for dissolution in case of a deadlock was not included in the new section because the Law Revision Commission felt that "While it would be possible for a corporation under the proposed statute to require a vote greater than a majority to control voluntary dissolution, in the opinion of the commission, the powers of a court of equity are sufficient to compel directors, at the suit of a stockholder, to institute proceedings under Article 9 of the General Corporation Law in a proper case where a deadlock was causing injury to the corporation. (Kroger v. Jaburg, 231 App. Div. 641 (1931); Gottfried v. Gottfried, 50 N. Y. S. 2d 951 (Sup. Ct. N. Y. Co. 1944).)" 1948 LEG. DOC. NO. 65(K), 1948 REPORT, LAW REVISION COMMISSION, pp. 7, 8.

unless there is a renewal for an additional period not exceeding ten years, as provided for by subdivision 3 upon recompliance with the foregoing conditions.

Section 9 in no way affects the already existing provisions of the Stock Corporation Law or the General Corporation Law, since as has already been pointed out, it is permissive legislation, limited in its application to those corporations which have complied with the procedure outlined in the section.

Generally, provisions of shareholders' agreements which forbid directors of a corporation from changing officers, salaries or policies, or to continue each other as directors, would still be invalid because directors may not by agreements entered into as stockholders abrogate their independent judgment; and, any contract impairing the discretion of a director will be void as against public policy.²⁸ Nor will Section 9 protect any individual guilty of fraud or acts of bad faith, for relief in such cases would be granted in a court of equity.²⁹ Agreements to continue directors in office may still be valid, notwithstanding the *Benintendi* decision and without complying with the conditions of Section 9, where all the stockholders are parties to the agreement, under the doctrine of *Clark v. Dodge*.³⁰ So also, a provision in the certificate of incorporation providing that the number of directors can not be changed except by the unanimous consent of all the shareholders would still be valid without complying with the section, under the decision in *Ripin v. U. S. Woven Label Co.*³¹

As has been seen above, compliance with Section 9 will permit the adoption of any or all of the four enumerated provisions. The provisions permitted by subdivisions 1 (a) (directors' quorum) and 1 (b) (directors' votes) are almost inextricably linked together. Assuming that the number of directors' votes necessary to transact business has been established, it would then become pointless to set the number necessary for a quorum of directors at a smaller figure. Therefore, the figure established for a quorum should be at least as great, or greater than, the number of directors' votes required to transact business, though in no event may it be less than one-third of the board. The converse of this, however, is not true, and the number of votes necessary for directors' acts may be less than the quorum figure, provided it is a majority of the quorum. Similarly, the same inter-relation exists between the third and fourth provisions

²⁸ See *Manson v. Curtis*, *supra* note 9.

²⁹ N. Y. STOCK CORP. LAW §9(4).

³⁰ See note 14 *supra*.

³¹ 205 N. Y. 442, 98 N. E. 855 (1912). However, to overcome the rule in *Matter of Boulevard Theatre & Realty Co.*, 195 App. Div. 518, 186 N. Y. Supp. 430 (1st Dep't 1921), *aff'd mem.*, 231 N. Y. 615, 132 N. E. 910 (1921), that a provision in a certificate of incorporation requiring a director to be elected by a unanimous vote of all the stockholders is invalid, compliance with Section 9 must be had.

relating to stockholders' quorums and stockholders' votes. A requirement of a greater than majority of directors for a quorum standing alone is undesirable. Where a certificate requires both unanimity for a directors' quorum and the unanimous vote of all directors present at a meeting for the transaction of any business, an absolute veto power is granted to each director in that his mere absence from the meeting will preclude the transaction of such business. The obvious result of this situation will make improbable any discussion or compromise that might have ensued had the absent director been present. Such result is in opposition to the beneficial theory behind the requirement that directors act as a board. Especially undesirable would be the quorum provisions standing alone when it related to a specified item of business only. In such case the exercise of that particular veto power would necessarily exclude the director from sitting in or voting upon any other business to be transacted at a meeting. The solution is in the use of both provisions.

Whatever elasticity this freedom of selection possesses, pales by comparison with the flexibility provided in the truly broad wording of each of the four permissible amendments. By its language the section permits the setting of these greater than majority or plurality requirements for all acts of the directors or stockholders or for one or more enumerated acts.

In other words not only may the corporation select any or all of the four provisions and adopt them, but even within any one provision it may restrict the directors or stockholders in their employment of these voting or quorum requirements to one or more specified situations. This becomes important when one appreciates that the true significance of Section 9 lies not in a newly created affirmative power of directors or stockholders to force action but rather in that Section 9 affords a veto power. Consider the typical situation wherein a director or stockholder who while fully desirous of permitting the corporation to be conducted in its every day affairs by those who are more qualified than himself, at the same time wishes to insure for himself permanent employment. If the requirements for directors' quorums or acts are set at such a level for all business so that the mere absence of the director will prevent the transaction of any business, the corporation is unduly hampered in its every-day affairs, and for no good reason, since the director or stockholder wishing to perpetuate his employment could have done so easily by specifying initially that the unanimity or qualified majority requirements be applied only when problems relating to dismissal of employees were before the board. From the foregoing then it is obvious that the wide variety of control provided by Section 9 as to directors' acts should be employed only to the degree necessary to effect the purpose of those implementing it. As to ordinary matters of the corporation there is wisdom in a rule by majority and even in the law of partner-

ships such is the rule unless expressly changed by the partners.³²

At common law only a majority of a board of directors was necessary to constitute a quorum and a majority of that quorum was empowered to transact business.³³ Section 27 of the New York General Corporation Law embodies the common law, but it does allow a change for it permits the by-laws to fix the number of directors necessary to constitute a quorum at a number less than a majority of the board, but not less than one-third of its number. Section 9 in no way affects this statute wherein it prescribes minimum limits but Section 9 does permit the exceeding of the requirement that the majority of the directors present may transact business, up to and including a requirement of unanimity.

With the passage of Section 9 any possible argument that these greater than majority requirements may not be set even without the aid of this section do not become superfluous, because to implement Section 9 the unanimous consent of the stockholders is necessary, and a situation wherein this might be impossible can easily be visualized. In this light it cannot be said by the reading of Section 27 that it is capable of one construction only. That the by-laws cannot fix the number of directors necessary to constitute a quorum at a figure less than one-third of its number is quite clear, but may they at a figure greater than a majority of its number? Is a provision to that effect in the certificate of incorporation or in an agreement between all stockholders valid? It is interesting to note, in this connection, that the words in Section 27 "unless otherwise provided" were followed in laws of 1892, c. 687 (a predecessor to Section 27) by the words "by law" and under such provision a quorum of directors must be a majority of all the directors unless otherwise provided in charter or special law, and by-laws could not change this rule, the word "law" being construed as having reference to an act of the legislature of equal dignity, force and character as the provision in question.³⁴ The words "by law" were deleted in 1904.³⁵ It is not unreasonable to argue that by such deletion the legislature had manifested an intent that the statutory pattern could be varied by the acts of the parties concerned, at least insofar as a provision regarding a quorum of directors is concerned.³⁶ But the Court of Appeals in

³² N. Y. PARTNERSHIP LAW § 40(8).

³³ *Ex parte Willcocks*, 7 Cow. 402, 17 Am. Dec. 525 (N. Y. 1827); *Benintendi v. Kenton Hotel*, 294 N. Y. 112, 119, 60 N. E. 2d 829, 831 (1945).

³⁴ OPS. ATT'Y GEN. 253 (1900).

³⁵ Laws of N. Y. 1904, c. 737, § 29.

³⁶ This was obviously the construction given to it in *Benintendi v. Kenton Hotel*, 181 Misc. 897, 900, 45 N. Y. S. 2d 705, 708 (Sup. Ct. 1943), where in determining whether a by-law requiring the unanimous vote of directors for any resolution of the directors, was inconsistent with law, the court said: "It is not altogether clear whether the 'Unless otherwise provided' clause of section 27 qualifies only the provision that a majority shall be necessary to constitute a quorum or whether it also qualifies the provision that the act of a majority

*Benintendi v. Kenton Hotel*³⁷ in referring to Section 27, said:

Section 27 modifies the common law rules only to the extent of permitting a corporation to enact by-laws fixing "the number of directors necessary to constitute a quorum at a number less than a majority of the board, but not less than one-third of its number." Every corporation is thus given the privilege of enacting a by-law fixing its own quorum requirement at any fraction not less than one-third nor more than a majority of its directors. But the very idea of a "quorum" is that, when that required number of persons goes into session as a body, the votes of a majority thereof are sufficient for binding action. . . . Thus, while by-law No. 3 (that requiring unanimity for all directors' resolutions) is not in explicit terms forbidden by section 27 . . . it seems to flout the plain purpose of the legislature in passing that statute. We have not overlooked section 28 of the General Corporation Law, the first sentence of which is as follows: "Wherever, under the provisions of any corporate law a corporation is authorized to take any action by its directors, action may be taken by the directors, regularly convened as a board, and acting by a majority of a quorum, except when otherwise expressly required by law or the by-laws and any such action shall be executed in behalf of the corporation by such officers as shall be designated by the board." Reading together sections 27 and 28 and examining their legislative history . . . , we conclude that there never was a legislative intent so to change the common law rule as to quorums as to authorize a by-law like the one under scrutiny. . . . A by-law requiring for every action of the board not only a unanimous vote of a quorum of the directors, but of all the directors, sets up a scheme of management utterly inconsistent with sections 27 and 28."

It is apparent that the court felt that, in view of the express language in Section 28, the court must first determine that a provision for a greater than majority of directors to constitute a quorum would be invalid (though such a provision was not directly involved in the case). It would then follow that the provision requiring unanimity for directors' acts would be clearly invalid since to allow it would, in effect, be allowing the first provision. This line of reasoning would not invalidate a by-law requiring for every action of the board a unanimous vote of a quorum of directors.³⁸

Wohl v. Avon Electrical Supplies is the only New York case found in which the validity of a provision requiring a greater than majority for a quorum was directly involved.³⁹ The provision was

shall be the act of the board. The only case the court has found on the subject is a Special Term decision upholding a by-law requiring a unanimous vote of directors for a sale of corporate assets in bulk, as being 'otherwise provided' under section 27. (Levin v. Mayer, 86 Misc. 116.)" The court thought it unnecessary to decide in view of N. Y. GEN. CORP. LAW § 28. It is to be noted that for election of directors N. Y. STOCK CORP. LAW § 55 expressly provides that a requirement for a quorum shall not exceed a majority.

³⁷ 294 N. Y. 112, 119, 60 N. E. 2d 829, 831 (1945).

³⁸ But see *Goldfarb v. Dorset Products*, — Misc. —, 82 N. Y. S. 2d 42, 44 (Sup. Ct. 1948), where the court in citing the *Benintendi* case said, "No valid provision may be made in a stockholder's agreement or otherwise requiring the concurrence of more than a majority of a quorum of the board of directors."

³⁹ 55 N. Y. S. 2d 253 (Sup. Ct. 1945). The provision involved was a re-

upheld, in reliance upon the reasoning of the lower court in the *Benintendi* case, on the ground that it was not inconsistent with law and not against public policy since Section 101 of the New York General Corporation Law would allow a petition for dissolution to be made by a majority of directors, in case of deadlock. The *Wohl* case was decided on April 2, 1945, and the authority and reasoning upon which it relied was reversed by the Court of Appeals in the *Benintendi* case, three days later, on April 5, 1945.

The foregoing has been written with a view toward determining whether a provision of greater than majority referable to a quorum of directors is valid without the aid of Section 9 of the New York Stock Corporation Law. The *Benintendi* case said it is invalid, although the court was not primarily concerned with that provision. Is that holding dicta? Was it necessary in order to reach the conclusion, which the court did, concerning a provision of unanimity for directors' acts? In the court's view of the case, it was. But, whether or not it was, there is little doubt that such a provision, couched in all-inclusive terms, would be invalid. The philosophy of the *Benintendi* case is that the price of exercising corporate privilege is conformity to the statutory scheme. Section 27 would be construed as declaratory of the common law permitting no change other than that expressly provided before. Influential in such construction might be the law's abhorrence of a deadlock (the *Benintendi* case view), the interrelation of Sections 27 and 28 of General Corporation Law⁴⁰ and the passage of Section 9 of Stock Corporation Law. Although Section 9 is intended to provide a means for control which would otherwise be invalid and not intended to invalidate that which would otherwise be valid, the latter result might very well follow. Until the *Benintendi* case is further construed the law is somewhat uncertain.⁴¹ Not unlikely will be the courts' temptation to rationalize, when called upon to construe the law, that the legislature in enacting Section 9 provided a means for variance from the statutory majority

quirement that five members of the board would constitute a quorum. It was a six-man board.

⁴⁰ See PRASHKER, CASES AND MATERIALS ON PRIVATE CORPORATIONS 972 (1937): "The rule requiring group determination is subject to exceptions. The courts have sustained directors' acts though they were not the result of board meetings where (1) the directors owned all the stock in a close corporation, or (2) the shareholders waived the holding of a meeting of the board of directors, (3) the custom or usage of the directors was to act separately and not as a board." A requirement of unanimity for a quorum not only increases the number of directors necessary to act but also gives each individual director an effective veto power.

⁴¹ The *Benintendi* case threw doubt on *Clark v. Dodge*, 269 N. Y. 410, 199 N. E. 641 (1936), which had caused belief that agreements between participants of a close corporation, provided all shareholders were parties to them, would probably be sustained when no public or creditor interest would be prejudiced, despite the fact that if strictly construed they might violate the statutory scheme.

or plurality, as the case may be, if, and only if the conditions precedent to the operation of the statute be complied with, *i.e.*, 1. appearance of provision in certificate of incorporation, 2. and in stock certificates, 3. duration of not more than ten years and, 4. consent of all participants; and that participants who fail to take advantage of the means available to them should not be allowed to alter the statutory pattern.⁴²

Most corporation laws, and New York's are no exception,⁴³ usually provide that the every-day affairs of a corporation shall be conducted by the board of directors. However, while some voice is given to stockholders in the conduct of the corporation, it is usually confined to what by comparison with every-day affairs might be called extraordinary matters. These are of two types; those which in the last analysis only the stockholders may act upon, such as selling or mortgaging the property or franchises, consolidation or voluntary dissolution; or those which while the directors have the power to act upon alone, they usually prefer to obtain stockholder approval. An example of this would be an executive pension plan which while the directors can legally establish it, is so inherently full of trouble in the nature of stockholders' suits that the stockholders' approval is extremely desirable.⁴⁴ The actions upon which the stockholders' approvals are mandatory are found in the Stock Corporation laws.⁴⁵ They, by individual specification, require either majority, qualified majority or plurality vote. Some require unanimity.

Section 9 changes this and now permits any qualification greater than the majority or plurality heretofore necessary⁴⁶ up to and in-

⁴² See *Israels, The Close Corporation and the Law*, 33 CORN. L. Q. 488, 504 (1948), to the effect that courts will probably tend toward strict construction of agreements entered into after September 1, 1948, and thus toward a holding that even an agreement to employ "X" for life and during good behavior depends on Section 9 for its validity and thus should be struck down unless arrived at by indirection under Section 9. *Israels* is also of the opinion that agreements forbidding removal of directors or change of number by statutory majority are probably invalid under the new statute because they appear elsewhere than in the certificate of incorporation.

⁴³ N. Y. GEN. CORP. LAW § 27.

⁴⁴ N. Y. STOCK CORP. LAW §§ 16, 19, 20, 36, 86, 105 and others.

⁴⁵ The thought apparently is that if stockholder approval is sought and obtained in possible later stockholder actions the directors' good faith is established and in addition there may be present the element of estoppel.

⁴⁶ Section 9 will not be permitted to decrease existing statutory requirements so that its effect on a statute such as Section 16 of the Stock Corporation Law which requires the approval of two-thirds of the stockholders in order for the directors to validly mortgage the property of the corporation will be to permit the increase of the approval from two-thirds up to and including unanimity. Section 51 of the Stock Corporation Law which permits under certain conditions limitations upon the right to vote insists under other conditions that the right to vote on specified items of business as enumerated shall not be prevented unless these conditions are met.

That Section 9 is to have no effect upon Section 51 was expressly declared in Laws of N. Y. 1948, c. 862, § 2, effective September 1, 1948.

cluding unanimity. It does not enlarge the area within which stockholders may act, for the words "any business" while general in scope doubtlessly mean business upon which they must vote or upon which they may vote. In short they will not be permitted to specify items of business as coming within the purview of their authority unless authorized by statute for by so doing they might very well be removing the affairs of the corporation from their mandatory management by the board of directors. Probably, however, they may apply the increased majority or plurality permission of Section 9 to "any business" or "any specified item of business" which though not required to be, happens to be presented to them by the directors. If this protection is not adequate for the stockholders' purposes, they then must resort to the method of first securing representation on the board of directors if they do not already possess it, and then by implementing Section 9, establish for this representative or representatives a veto power.

This method is to be preferred for two reasons. First it prevents the possibility that the protective devices of the stockholders will be found to be invalid in that they are sterilizing the board of directors. Secondly if the stock is not extremely closely held the problem of stalemate, inherent in all these means, is greatly magnified, since experience has shown that stockholders are even more prone than directors to disagree. If the stock is so held that the directors and the shareholders are the same, and they hold the stock in equal proportions, the danger of disagreement is not as acute, but the possibility of invalidity still makes it desirable to restrict at the board, rather than stockholder level. For the stockholder who is not a director and who is unable to secure representation on the board, there is, of course, left to him only the method of establishing the quorum and voting requirements at such a level so that his absence or negative vote exercises a veto power. Realistically however, it is probably true that any stockholder who cannot secure board representation will also be unable to establish those requirements at the necessary level, if indeed he can do so at all.

Whether Section 9 should be used, and, if so, to what extent, depends, in the final analysis, upon the objectives of the participants of the corporation. Should the objectives be attainable apart from Section 9, then the section ought to be disregarded because of its technical requirements and because its protection can be no longer than of ten years' duration. It follows that in the consideration of how best to provide for the protection desired, thought must be given to the nature of and the law concerning shareholders' agreements, employment contracts, voting trusts, cumulative voting, restrictions on transfer and cross option agreements on stock, classification of shares and any other protective measures available apart from or within Section 9. A few examples will serve to illustrate what has been said.

If the participants desire that none but the original participants shall ever be members of the corporation, without the consent of all concerned, Section 9 does not aid them. But their desire, may be affected by an agreement giving each other, or to the corporation, or both, an option to purchase the shares of the participant who is desirous of selling before the same are offered to outsiders.⁴⁷ An agreement between the owners of all the stock of a corporation that in the event of death of any one of them, one of the survivors should have an option to buy the stock held by the deceased shareholder at a certain price within a certain time, although designed to perpetuate control of the corporation in the hands of the parties to the agreement and their survivors, is not illegal as restricting the right to alienate property.⁴⁸

If a minority stockholder seeks representation on the board of directors so as to influence ordinary matters, cumulative voting would be effective provided that his proportionate holdings are at least equal to the proportion that "one" bears to the total number of directors. This method, however, is subject to the powers of the majority to change the number of directors or issue new shares. But as to the change of number of directors, a requirement of unanimous shareholders' consent is valid.⁴⁹ As to the issuance of new shares, unless preemptive rights afford protection there may be none. In such case, a requirement of unanimity of directors for a quorum or for any act is not helpful but a requirement also valid by Section 9 of unanimous consent of shareholders for amending the certificate of incorporation as to issuance of new shares is foolproof for ten years. The issuing of classes of shares in which each class would be entitled to elect a specified proportionate number of directors is effective if the votes or consents of the holders of a majority of each class of shares are required for amending the certificates of incorporation so that the shares could not be reclassified or new shares issued, or number of directors changed without such consent.⁵⁰ Possibly a voting trust agreement might require the trustees to vote for named individuals and be enforceable.⁵¹ Such agreements are subject to a ten-year limitation.

If a minority stockholder desires to be a director he may secure such position by an agreement with all other stockholders to elect

⁴⁷ *Bloomington v. Bloomington*, 107 Misc. 646, 177 N. Y. Supp. 872 (Sup. Ct. 1919), upholds such an agreement. The shares must be appropriately stamped as required by N. Y. PERS. PROP. LAW § 176. See also *Brown v. Button*, 41 App. Div. 57, 58 N. Y. Supp. 353 (4th Dep't 1899).

⁴⁸ *Scruggs v. Catterhill*, 67 App. Div. 583, 73 N. Y. Supp. 882 (1st Dep't 1902).

⁴⁹ *Ripin v. U. S. Woven Label Co.*, 205 N. Y. 442, 98 N. E. 855 (1912), which was specifically distinguished in *Benintendi v. Kenton Hotel*, 294 N. Y. 112, 119, 60 N. E. 2d 829, 831 (1945).

⁵⁰ N. Y. STOCK CORP. LAW § 51 apparently authorizes this type of class voting. The statute has not yet been tested in a court action.

⁵¹ *Cf. McQuade v. Stoneham*, 263 N. Y. 323, 189 N. E. 234 (1934).

each other directors.⁵² It is not against public policy or unlawful per se for stockholders to agree or combine for the election of directors or other officers, so as to retain control of the corporation.⁵³ Such agreement is not unlawful since, under it, the directors are still elected by a plurality of votes as the statute mandates.⁵⁴ A voting agreement to elect the three parties holding all the stock as directors and officers, as long as they hold their stock, is valid.⁵⁵ A breach might be enjoined before the voting. But under Section 47 of the Stock Corporation Law, a shareholder's vote may not be challenged except on the basis of his not being a stockholder of record or a duly authorized proxy of such.⁵⁶ Protection is afforded by a requirement of unanimity for election of directors which would be valid under Section 9.

If a minority stockholder desires employment with the corporation, which is usually the dominant objective in a close corporation, in most cases an ordinary employment contract, in the form of an agreement between all stockholders, suffices provided that the employee is subject to the control of the board of directors.⁵⁷ An agreement among all stockholders to elect particular officers is not objectionable.⁵⁸ These methods are to be preferred over a provision, pursuant to Section 9, requiring unanimity of directors' consent to remove any officer or employee.

The foregoing examples are illustrative of the predominant objective of members of close corporations. They indicate that the majority of the objectives are attainable outside of Section 9. From this fact coupled with the ten-year limitation and the technical requirements of Section 9, the conclusion is inescapable that lawyers will tend to avoid that section. The direct method is to be desired over any indirect method.

⁵² *Fells v. Katz*, 256 N. Y. 67, 175 N. E. 516 (1931). See *Benintendi v. Kenton Hotel*, 294 N. Y. 112, 117, 60 N. E. 2d 829, 830 (1945).

⁵³ *Havemeyer v. Havemeyer*, 43 N. Y. Super. Ct. 506 (1878).

⁵⁴ See *Benintendi v. Kenton Hotel*, *supra* note 52.

⁵⁵ *Harris v. Magrill*, 131 Misc. 380, 226 N. Y. Supp. 621 (Sup. Ct. 1928).

⁵⁶ An application under N. Y. GEN. CORP. LAW § 25 to set aside an election in breach of shareholders contract would be denied. The appropriate remedy is a plenary action for specific performance. *In re Roosevelt Leather Hand Bag Co., Inc.*, 68 N. Y. S. 2d 735 (Sup. Ct. 1947).

⁵⁷ N. Y. STOCK CORP. LAW § 60 expressly requires that officers and employees be subject to the control of directors.

⁵⁸ "Although a provision in such an agreement that all the stockholders will continue to vote for themselves as directors is legal, a provision for the continuance of specified persons as officers and employees is valid only if such persons remain faithful and efficient. . . ." *In re Roosevelt Leather Hand Bag Co., Inc.*, 68 N. Y. S. 2d 735, 736 (Sup. Ct. 1947). ". . . where the directors are the sole stockholders, there is no objection on ground of public policy to enforcing an agreement among them to vote for certain persons as officers . . . Such agreement, however, must be construed as one to retain the named persons as officers only so long as they remain faithful and efficient." *Matter of Block*, 186 Misc. 945, 949, 60 N. Y. S. 2d 639, 642 (Surr. Ct. 1946).